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COSTA RICA
POLICY TOOLS FOR RURAL FINANCE

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RURAL FINANCIAL POLICIES

by

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I. Agricultural Credit: From Success Story to Crisis

In many ways, for a long time Costa Rica had been a success story with respect to agricultural credit. The authorities had become interested in small-farmer credit issues as far back as 1914, when the first state-owned bank, the Banco Internacional de Costa Rica (today, the Banco Nacional de Costa Rica) was created. At that time, the Cajas Rurales de Crédito were organized, "to liberate small farmers from the usurious conditions of moneylender loans, and to stimulate production of basic grains for domestic consumption."

By the end of 1915, the bank had established 27 Cajas and was lending to 1,000 small farmers the equivalent of 15 percent of its porfolio (Gonzalez-Vega, 1973). Moreover, since the middle of the nineteenth century, the coffee beneficios had operated, in effect, as small rural banks. Even today, loans from coffee processors and cooperatives represent an efficient credit delivery system that finances a substantial portion of the credit demand of thousands of coffee growers (Morris, 1982).

When in 1936, the Banco Internacional de Costa Rica was converted into the Banco Nacional de Costa Rica (BNCR), the Cajas became the Juntas Rurales de Crédito Agrícola (rural boards for agricultural credit), but the concept of credit allocation by a board of local community members was maintained.

In 1957 the other three state-owned banks were legally required to provide small-farmer credit. The Oficinas de Crédito al Pequeño Agricultor were created as part of their Commercial Departments (Gonzalez-Vega, 1973). These Oficinas never amounted to more than an additional window (credit line) at these other banks, usually located in major towns only. The amounts which they disbursed were not insignificant, nevertheless.

As a consequence of these institutional innovations and of the generalized process of financial deepening that the country experienced during the 1960s and most of the 1970s, Costa Rican farmers enjoyed a comparatively ample access to credit (Gonzalez-Vega, 1988). While in the early 1970s, it was estimated that only about 5 percent of all farmers in Africa and about 15 percent of those in Asia and Latin America had had access to institutional loans, this proportion was over 30 percent in the case of Costa Rica (World Bank, 1974, Donald, 1976). If bank credit delivered to coffee producers through the beneficios is considered as formal credit, this proportion was close to an exceptionally high 45 percent (comparable to Korea at that time).

Moreover, agriculture always enjoyed substantial shares of the total bank loan portfolio. By 1960, while the average proportion of agricultural loans with respect to total domestic credit for the private sector was 22 percent among 18 Latin American countries, it was 60 percent for Costa Rica, the highest proportion in the Hemisphere (Adams, 1971). By 1973, these proportions were 24 percent for Latin America and 52 percent for Costa Rica.

Table 1. National Banking System. Credit Volumes. Index: 1978:100.

	1970	1975	1978	1981	1982	1983
Credit outstanding (end of December):						
Total	50.3	71.5	100.0	46.1	35.5	51.0
Crops	78.5	72.9	100.0	51.5	46.0	72.6
Livestock	56.1	78.0	100.0	43.4	37.7	55.9
Industry	38.1	69.5	100.0	38.8	33.2	51.0
Commerce	24.3	89.6	100.0	65.9	46.7	42.9
Services	31.7	57.0	100.0	37.6	19.2	21.9
Housing	40.1	55.9	100.0	54.1	32.6	39.5
Personal	41.8	86.5	100.0	46.7	18.6	15.1
New loans granted during the year:						
Total	57.9	87.7	100.0	50.7	48.5	58.1
Crops	94.6	102.7	100.0	75.8	91.2	106.9
Livestock	50.1	65.3	100.0	47.1	60.8	65.6
Industry	49.2	90.6	100.0	32.7	37.2	48.0
Commerce	38.3	133.8	100.0	103.0	58.7	59.9
Services	84.9	126.7	100.0	70.7	11.2	14.5
Housing	23.6	56.7	100.0	40.4	21.6	36.8
Personal	20.4	40.9	100.0	25.3	10.4	13.7

Source: Gonzalez-Vega (1985)

That is, the agricultural sector showed more flexibility to adjust to the recession, while the authorities channelled funds towards this sector, in view of its importance in terms of export earnings and food prices. As a consequence, the share of agriculture in the portfolio of credit outstanding grew to 51 percent, while the share of the sector in the flow of new loans jumped to 63 percent. Although the real value of the amounts disbursed was low, the proportion increased sharply.

Indeed, during the 1980s, the proportion of delinquent loans in the portfolios of the state-owned banks increased to alarming levels, reflecting either the lack of ability or the absence of incentives for farmers to repay their loans, as well as the reduced willingness and/or ability of the banks to collect those loans. This made those farmers not eligible for more credit.

In some cases the crisis as well as other changes in the external and domestic circumstances may have resulted in difficulties to repay. In many cases, however, the expectation that the interest rates attached to new loans would be higher, the fear to lose their position in the rationing queue, or the expectation of rescheduling options may have represented strong incentives for borrowers to delay repayment. The resulting high level of arrears and default further reduced the effective volume of the loanable funds available for new projects and seriously compromised the financial viability of the state-owned banks.

These developments have been accompanied by intense lobbying, legislation, and demands from pressure groups for government intervention, to guarantee that a minimum share of the loan portfolio be allocated to the agricultural sector, to secure the continuation of interest-rate subsidies for agriculture and small farmers, and to obtain the reschedulling and, potentially, a moratorium of old delinquent debts.

Moreover, several international donors have been formally approached by the Costa Rican authorities, with the request that substantial new amounts of foreign funds be channelled into agricountry's comparative advantages, to new areas of potentially greater private and social profitability. In the absence of these resource reallocations, the economy will not optimally respond to the challenges and opportunities of the new economic environment.

Moreover, for Costa Rican firms and producers, including numerous farmers, bank loans have traditionally represented the most important source of funds, both for investment and for working capital. Particularly in the more modern (capital-intensive) sectors of the economy, there has always been a heavy reliance on debt, rather than on equity and other financial instruments. On the supply side, on the other hand, loans from the four state-owned commercial banks have traditionally represented the largest share of the available loanable funds.

The dominance of the state-owned banks has been a result of the legally-sanctioned monopoly of the mobilization of monetary deposits, enjoyed by these banks. Given the large share of monetary instruments in the portfolios of financial assets of firms and households, a common feature of developing countries, this monopoly has given the state-owned banks an exceptional advantage, despite major deficiencies in their operations, and has represented a serious restriction to entry into financial markets.

Furthermore, the performance of the NBS both contributed to and was seriously jeopardized by the crisis. From a structural perspective, in the early 1980s the NBS was considered to be "slow, excessively conservative, and incapable of significantly

Almost insignificant in the early 1980s, on the other hand, the share of the private banks and of the private regulated _financieras_ in total domestic loan portfolios rapidly augmented in recent years. These private entities have financed their lending operations with their own equity, foreign borrowing (and deposit mobilization offshore), and with domestic time deposits (_certificados de inversión_) with terms over six months (over three months recently). An amendment of the Central Bank Law in August of 1984 enabled these private banks to rediscount with the Central Bank, when the funds used had been provided by international donors.

This amendment gave USAID the opportunity to provide substantial support to the private banks, whose share in the total flow of new loans expanded from about 6 percent in 1983, to 21 percent in 1986 and further increased in 1987. During the same period, the share of the private regulated _financieras_ increased from 3.8 to 7.3 percent of the total, as funds shifted towards intermediaries able to offer more attractive rewards to depositors. These entities have been subject to less severe Central Bank constraints (reserve requirements) and regulations and have offered their clientele higher quality financial services.

Also, the _Bolsa Nacional de Valores_, several savings and loan associations (_mutuales_), and about 50 credit unions, particularly those associated with FEDECREDITO, have further contributed to the diversification of the Costa Rican financial system and to greater competition in the market for funds. The depositors have been the beneficiaries from this competition.

This is not surprising, however. The infrastructure and expertise requirements of industrial lending more closely match the capabilities and inclination of the private banks, than is the case with agricultural credit. Also, risk is easier to evaluate, industrial loans are larger, and average administration costs are lower.

On the other hand, before 1985 the private banks had granted less than one percent of the total flow of new loans for agriculture. By 1986, however, this proportion had increased beyond five percent, but the agricultural lending activities of the private commercial banks were still highly concentrated in a few, large loans and were primarily directed towards a few export crops, particularly coffee and non-traditional products.

Between 1983 and 1986, the share of agricultural loans in the portfolio of the private banks ranged between 2.2 and 6.9 percent. Although their lending for agriculture will inevitably expand, this will be a slow process. Mostly, they will lend for agricultural projects of clients that are well known to them, due to earlier non-agricultural loan transactions. It will take a long time until they develop the infrastructure and expertise required. In addition, the high cost of their funds will reduce their competitiveness in this market. Thus, a share of lending equivalent to what they have acquired in the industrial credit market is unlikely in the near future. This will in part reflect, nevertheless, the market imperfection that results from the state-owned banks' monopoly of monetary deposit mobilization.

In general, the contributions of the financial system to investment and growth will depend on the volume of resources intermediated (both deposits and loans), measured in real terms, and of the efficiency with which financial services are supplied. This efficiency is best measured by the magnitude and dispersion of the transactions costs imposed on all (actual and potential) market participants as well as by the dispersion of the marginal rates of return of the investments and productive activities undertaken (the degree of market fragmentation).

Conclusion Number Two:

The main objective of financial policy reforms and donor interventions must be to increase the real flow of domestic claims on resources that are intermediated and to reduce the transactions costs for all market participants (depositors, intermediaries, and borrowers).

In the past, rigid financial policies constrained the growth and modernization of the Costa Rican financial system. While the absence of inflation through the 1970s contributed to the expansion of the volumes of domestic financial assets and liabilities, in real terms, distortions in the structure of interest rates, loan targeting, and other quantitative credit controls (topes de cartera) contributed to market fragmentation and the non-price rationing of loans.

Moreover, excessive bureaucracy in the state-owned banks, detailed regulations, and unnecessary reliance on Central Bank directives on the part of the commercial banks, sharply increased transactions costs and rigidity in the operation of the banks.

The USAID further contributed to the expansion of the private banks, within a new policy environment which increasingly promoted competition. Some of the goals of the World Bank structural adjustment program have also promoted the development of a more efficient financial market.

Conclusion Number Three:

> **Fiscal and monetary control is key for successful financial growth. This requires careful Central Bank stabilization policies. Financial-policy reforms, in order to promote competition, to bring interest rates closer to their equilibrium levels, and to reduce the scope of quantitative credit controls and non-price rationing are also crucial for financial progress in Costa Rica. This, in turn, is a precondition for a successful economic recovery.**

Costa Rica faces a major challenge. Beyond the need for a continuing concern for fiscal and monetary stability, where much progress has been made, but where control has not been entirely achieved yet, the authorities must undertake a complete revision of the country's development strategy and facilitate a major reallocation of resources. The financial sector must play a key role in this process. This cannot be accomplished, however, with marginal procedural interventions or specific credit projects. The effort will be successful only if the whole financial system is involved, including both the state-owned and the private intermediaries, both bank and non-bank institutions.

The USAID must continue with these efforts, which will lead to particularly substantial fruits in the medium term. Support for the private banks and other non-bank private financial intermediaries will not be, nevertheless, sufficient to remove the obstacles faced at present by numerous agricultural producers. A short-term strategy, including the state-owned banks, is needed.

Despite the rapid changes in market structure observed, the state-owned banks still represent the bulk of the financial system. This is particularly true when one considers, not only the amounts of credit disbursed, but also the number of clients (borrowers as well as depositors) with access to their services. By the mere fact of their size, the performance of the state-owned banks critically influences the quality of the financial services provided and, thereby, the extent to which the financial system is, in the aggregate, contributing to rapid economic growth and structural transformation. If these banks remain grossly inefficient, they will impose major constraints on other private economic activities.

Moreover, it is clear that the private banks are more efficient (cost effective) than the state-owned banks in the specific areas of their operations, which are rather restricted. Because of the profit objectives that they pursue and of their much less bureaucratic constraints and political interferences, they can become, in the long run, more efficient than the state-owned banks in other areas of operation. Potentially oligopolistic behavior might, however, reduce this efficiency.

Conclusion Number Five:

The state-owned banks cannot be ignored in an effort to improve the Costa Rican financial system, in view of their size, the extent of their infrastructure, their monopoly of monetary deposit mobilization, and the heterogeneous nature of their operations.

There are several reasons that suggest that the most effective strategy for the improvement of the Costa Rican financial system involves the promotion of several types of intermediary, including a substantial effort to upgrade the performance of the state-owned banks. Arguments to include the government banks in the effort are:

(a) **Because of their size, even comparatively minor improvements in the efficiency of the state-owned banks will weight very large.**

If, on the other hand, the performance of these banks is not improved, their inefficiency will represent a major bottleneck to the expansion of the private non-financial sectors as well as a critical constraint to the process of structural adjustment.

(b) There are two ways to promote private-sector development in Costa Rica: through the expansion of the private banks, with most of the potential gains in the medium term, and through the removal of one of the major constraints to private-sector development, namely, the inefficiency of the state-owned banks, which has immediate short-run implications.

a major source of their funding will be public. Abundant access to these funds may reduce the need or desire to mobilize domestic resources. Credit allocation criteria may be distorted by the source of the funding.

Moreover, although the monopoly in the mobilization of monetary deposits allows the state-owned banks to provide a service of lower quality to its depositors (in particular, to impose on them high transactions costs), oligopolistic tendencies within the private banks may result in allocations of loanable funds that do not necessarily always reflect social profitability. In particular, the private banks may be in a position to favor, in their credit allocation decisions, groups of investors closely related to the bank, and to transfer to them the subsidy implicit in flows of public (donor) funds to these institutions.

Furthermore, the provision of deposit services is as important for economic efficiency and growth as the granting of loans. Deposit services in Costa Rica have been of very low quality and the state-owned banks have not implemented a consistent deposit mobilization strategy, particularly in the rural areas (Poyo, 1988). Improvement of this dimension of the financial market requires, in view of the legal monopoly, concern with the efficiency of the state-owned banks.

(d) **The state-owned banks possess an extensive infrastructure of branches, which allows them to cost-effectively reach an ample clientele, particularly in the rural areas, beyond the present capabilities of the private banks.**

Unles the state-owned commercial banks compensate with lower transactions costs and better service the loss of subsidies for their clients, too strong political pressures will develop that may cause a reversal of the new policy orientation.

In effect, given the political economy environment, the four state-owned banks must become more efficient, for the reforms not to be rejected. Poor quality of service at the state-owned banks may even generate a political backlash of restrictions and supression against the private commercial banks. This will be particularly unfortunate, since the reforms are key for a recovery.

The identification of deficiencies and problems in an evaluation of the performance of the state-owned banks was not a surprise. Earlier studies had already uncovered many of these shortcomings, while theoretical considerations about the nature of the institutional structure and set of incentives for decision making in the state-owned banks predicted these findings. The presence of a significant process of change and of major institutional tensions leading towards an improvement in their performance and viability, on the other hand, was a major surprise (Cedeño, 1988; Jiménez, 1988).

The presence of this internally-generated process of change, albeit as a response to deregulation and competition in the market, suggests the existence of a viable, feasible opportunity for improvement. The identification of the major deficiencies indicated areas of possible intervention for the authorities and the donors.

(b) Deposit mobilization is not viewed as a service to the clients, but mostly as an activity complementary of lending, required to purchase the "inputs" for the production of loans. There is not an overall strategy of deposit mobilization, but rather ad hoc reactions to the demands for loanable funds at particular moments. Financial intermediation, however, must be a service for both depositors and borrowers.

The state-owned banks have been, for the most part, borrower-dominated agencies, concerned with disbursing funds, but with little preoccupation for the quality of the services offered to depositors. Rural deposit mobilization has been entirely ignored. This is a major deficiency that needs to be corrected. Such an effort offers substantial room for gains both for the banks and their clients.

(c) The transactions costs imposed on the clients (borrowers and depositors) of the state-owned banks have, in general, been extremely high and, until recently, these banks had shown no understanding or concern for these costs. Recent studies about borrowing and lending costs show that these are high, greatly dispersed, and highly correlated with loan size (Gonzalez-Vega and Gonzalez-Garita, 1988). As a result, transactions costs have a very regressive impact on distribution.

Small and risky producers find that the total cost of institutional funds is very high, while depositors find that the net returns to their savings are very low. High costs of lending and of mobilizing funds further reduce bank financial viability.

Several circumstances indicate that there is willingness and scope for improvement within the state-owned banks, including:

(a) New managerial teams that have been able to define consistent objectives for the institutions and that are committed to change.

(b) Numerous new initiatives for improvement in procedures and the quality of the services offered, many of which have been promoted by the mid-levels of the staff. The old bureaucracy has been slowly replaced by better-trained staff.

(c) A new awareness that the client's interests, rather than regulations, procedure, or documentation should guide efforts of reform.

(d) The desire to introduce new products, compete, and be flexible, in order to survive in a deregulated, more competitive market.

(e) The quality of the stock of human capital at the banks, combined with a willingness to improve and adjust to changes in the environment.

The greatest threat to the commercial banks will always be their vulnerability to political intrusion* (Mesalles, 1988). This, and the potential conflicts of objectives in decision-making, will always be a limitation of the state-owned banks. They will continue to be, however, a most important component of the Costa Rican financial system. The challenge is, therefore, how to support their improvement and, at the same time, provide them with defenses against these intrusions.

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